




DEPARTMENT OF MENTAL HEALTH POLICY/PROCEDURE

SUBJECT FINANCIAL RESPONSIBILITY REQUIREMENTS FOR EXISTING DMH CONTRACTOR	POLICY NO. 812.03	EFFECTIVE DATE 04/28/2009	PAGE 1 of 9
APPROVED BY:  Director	SUPERSEDES 412.2 04/28/2009	ORIGINAL ISSUE DATE 04/28/2009	DISTRIBUTION LEVEL(S) 1, 2

PURPOSE

- 1.1 To establish the financial responsibility requirements and procedures for contractors that have a Legal Entity Agreement (LEA) with a current Term with the County of Los Angeles Department of Mental Health (DMH)
 - 1.1.1 Such financial requirements shall be consistent with the principles of County contracting set forth in the County's *Orientation to Basic Principles of County Contracting* collaboratively issued by the Auditor-Controller, County Counsel, Department of Human Resources, and Internal Services Department.
 - 1.1.2 The DMH shall conduct annual reviews of LEA contractors' financial statements.
 - 1.1.3 The results of the analysis are intended to inform DMH management about the financial solvency of each LEA contractor thereby:
 - 1.1.3.1 Improving the DMH's decision making process for current and future contracting; and
 - 1.1.3.2 Facilitating the identification of any contractors that may be experiencing financial difficulties. In this situation DMH will be better able to take timely action in assisting a contractor which because of its financial position may present unnecessary risk to either client care or to the County's public interest.
- 1.2 To identify which types of contracts are waived in part or in whole from this Policy/Procedure and the reasons for the waiver.
- 1.3 This policy is not applicable for a prospective contractor that does not have a contract with a current Term with the DMH. Prospective contractors soliciting the DMH for a contract are referred to DMH Policy # 1002.01.

POLICY



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- 2.1 Nothing in this policy is intended to limit or restrict the ability of the DMH to conduct any reviews it deems appropriate during a contract period, including but not limited to the financial viability assessments which are the subject of this Policy.
- 2.2 The DMH shall perform an annual analysis of each contractor's financial statements to determine the financial viability status of the contractor.
- 2.2.1 A contractor shall submit current compiled, reviewed, or audited financial statements annually. Under normal circumstances, "current" refers to the financial statements for the immediate preceding year. The DMH will not accept financial statements for a fiscal year or year ending period that is more than 18 months prior to their submission to DMH. The economic size or revenue base of the contractor will dictate the format of the financial statement that must be submitted for evaluation.
- 2.2.2 A contractor with annual revenues averaging up to \$49,999 must submit compiled, reviewed or audited financial statements.
- 2.2.3 A contractor with annual revenues averaging from \$50,000 - \$499,999 must submit reviewed or audited financial statements.
- 2.2.4 A contractor with annual revenues over \$500,000 must submit audited financial statements.
- 2.3 Contractors, as identified in Attachment I *Non- Legal Entity Agreement Contractors - Full or Partial Waiver From Annual Re-evaluation Requirements*, that do not have a Legal Entity Agreement are required to submit the above mentioned financial statements only when renewing their contracts or merging/acquiring another entity, or may be exempt from submitting financial statements. This is because other conditions are applicable such as State Provider participation requirements, there is no or minimal risk to mental health clients in the event of default, another County Policy/Procedure is controlling, and/or the entity is another government or quasi-government entity. These non-Legal Entity Agreement contractors are paid only in arrears during the Term of their agreement/contract/MOU with the DMH.

DEFINITIONS



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- 3.1 Compiled Statements - A compilation is the presentation, in the form of financial statements, of the representation of the owners or managers with no assurance made by the Certified Public Accountant (CPA). As a result, compiled financial statements are substantially less costly than audits or reviews.
- 3.2 Reviewed Statements - The statements look just like those from an audit, but the independent accountant's report does not provide quite the level of assurance that an audit does. The report typically concludes that nothing came to the reviewer's attention to cause them to believe that the financial statements were not prepared in accordance with the Generally Accepted Accounting Principles (GAAP).
- 3.3 Audited Statements - may either be in a Securities and Exchange Commission Form 10-K or annual report. Only audited statements have an opinion of a CPA.
 - 3.3.1 Unqualified Opinion - When an auditor has expressed an opinion on the basis of an examination of the entity's financial records made in conformity with generally accepted auditing standards and when the financial statements fairly present the financial position, results of operations and changes in financial position in accordance with GAAP and include appropriate informative disclosures.
 - 3.3.2 Qualified Opinion - When an auditor issues qualifications to the opinion. Usually "except for" (such as not accounting for certain things in accordance with GAAP) or "subject to" (such as litigation where outcome is not known). The auditor identifies the qualifications, reason, and impact on the statements.
 - 3.3.3 Adverse Opinion - When the financial statements do not fairly present the entity's financial position and the unfairness is material enough so as not to elicit a qualified opinion.
 - 3.3.4 Disclaimer of Opinion - No opinion at all due to lack of independence of the auditor, material uncertainties not under the entity's control, or no audit was performed.



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3.4 Liquidity Ratios - This refers to the ability of an entity to meet its short-term financial obligations when and as they fall due. There are two (2) liquidity ratios that apply to this process and they are as follows:

3.4.1 Quick Ratio - Sometimes called Acid Test Ratio, is calculated by adding cash, short-term investments, and accounts receivable divided by current liabilities. Similar to current ratio but is considered a more reliable indication of an entity's ability to meet its obligation.

3.4.2 Current Ratio - Total current assets divided by total current liabilities. The entity's financial position is stronger and more liquid as the current ratio increases.

3.5 Profitability Ratio - This ratio is addressed below:

3.5.1 Expense to Income Ratio - Total expenses before taxes minus non-cash expenses (i.e., depreciation, amortization, etc.), and other charges due to reserve/contingency transaction(s) divided by Gross Income. It measures the ability to generate income in excess of expenses. A lesser ratio indicates better financial operations for the entity.

3.6 Tangible Net Asset (Equity) Requirement:

3.6.1 Total Assets, excluding goodwill, patents, copyrights, trade names, secret formulas, franchises, licensing, leasehold costs, and organizational costs (if there's any) minus Total Liabilities. An entity must have at least positive balance or more in net asset to pass the requirement, an agency with negative balance is considered weak.

PROCEDURES

4.1 Pursuant to the contract terms, a contractor must annually submit to the DMH Contracts Development and Administration Division (CAD) a current audited, reviewed, or compiled financial statement. A financial statement is considered "current" if fiscal year or year ended period is less than 18 months prior to their submission to DMH.



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- 4.2 Upon receipt of the contract negotiation package, CDAD completes Attachment II *Request for Financial Viability Review* and submits the completed form together with the contractor's financial statements to the Financial Services Bureau, Fiscal Audit Monitoring Section (FAMS).
- 4.3 FAMS staff (evaluator), using Attachment III *Financial Statement Analysis for Non-Governmental Organization (NGO)* form evaluates the financial statements for appropriateness, the nature of the auditor's opinion (applicable for audited financial statements only), and the determination of financial ratios.
 - 4.3.1 Evaluator determines the financial statement type as defined by the County standard, the extent of completeness, and timeliness status.
 - 4.3.2 Evaluator ascertains that the opinion was rendered by the independent auditor, i.e., unqualified, qualified, etc. (applicable for audited financial statements only).
 - 4.3.3 Evaluator determines, as indicated by the County standard, the contractor's quick, current, expense ratios, and net assets.
- 4.4 Solvency/Working Capital grading/review criteria:
 - 4.4.1 Quick ratio: purpose - to evaluate that the available cash and quickly convertible to cash assets are sufficient to meet current liabilities.
 - 4.4.1.1 Short-term securities/investments are assumed to be valued at current fair market value for purposes of this financial ratio evaluation. Any changes made on the value of securities/investments as originally shown on the financial statement(s) that will affect the result of financial ratio evaluation would require the contractor to provide a proof certified by its CPA.
 - 4.4.1.2 Formula: $\text{cash} + \text{short-term investments} + \text{accounts receivable} / \text{current liabilities}$.
 - 4.4.1.3 Criterion: must be fair or good.



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(1) Weak: <1

(2) Fair: >1<2

(3) Good: >2

4.4.2 Current Ratio: purpose - to evaluate that the current assets are sufficient to satisfy current liabilities.

4.4.2.1 Short-term securities/investments are assumed to be valued at current fair market value for purposes of this financial ratio evaluation. Any changes made on the value of securities/investments as originally shown on the financial statement(s) that will affect the result of financial ratio evaluation would require the contractor to provide proof which is to be certified by its CPA.

4.4.2.2 Formula: current assets / current liabilities

4.4.2.3 Criterion: must be fair or good.

(1) Weak: <1

(2) Fair: >1<2

(3) Good: >2

4.4.3 Expense/Income ratio: purpose - to evaluate the contractor's ability to generate sufficient income to meet its expenses.

4.4.3.1 Adjustment of expenses may be made for any non-cash expenses for purposes of this financial ratio evaluation. Example of non-cash expenses are depreciation and amortization. Adjustment for one-time transactions and/or events such as reserve/contingency set aside(s) in a year may also be considered. One-time events will be dealt with by the DMH on a case-by-case basis.

4.4.3.2 Formula: expenses before taxes - non-cash expenses – any one-time event expense(s) / gross income.

4.4.3.3 Criterion: must be fair or good.



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(1) Weak: >1

(2) Fair: =1

(3) Good: <1

4.4.4 Tangible Net Asset requirement: purpose - to evaluate longer term financial viability.

4.4.4.1 Intangible assets are not physical in nature. The term intangible is applied for accounting purposes to all nonphysical property including organizational costs, leasehold costs, goodwill, patents, copyrights, trade names, secret formulas, franchises, and licensing.

4.4.4.2 Tangible assets including short/long-term investments and real property may be valued either at cost or current fair market value for purposes of this financial viability ratio evaluation. Any changes made on the value of securities/investments and fixed assets as originally shown on the financial statement(s) that will affect the result of financial ratio evaluation would require the contractor to provide proof which is to be certified by its CPA.

4.4.4.3 "Tangible Net Assets" means tangible assets less total liabilities.

4.4.4.4 Formula: (total assets - intangible assets) - total liabilities.

4.4.4.5 Criterion: must be "pass"

(1) Weak: Negative tangible net assets.

(2) Pass: Positive tangible net assets.

4.5 Upon completion of the analysis, FAMS prepares the financial viability report.

4.5.1 Whether a contractor meets or does not meet all or any of the four review criteria as part of the evaluation process, FAMS notifies the CDAD and the Program Deputy Director, provides a copy of the report to the Director of Financial Services, and informs the contractor by mail on the result of the viability evaluation.



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- 4.5.2 A contractor that does not meet all or any of the four review criteria may appeal in writing to the DMH Director. The Director or his designee will forward the contractor's appeal letter and supporting documentation to the Director of Financial Services or Administrative Deputy for re-evaluation of the contractor's financial statements. Such re-evaluation will be on the basis of the information and documents submitted to the Director as part of the appeal process. The result of the re-evaluation will be subjected to review and approval of the Director of Financial Services or Administrative Deputy. The original copy of the re-evaluation report will be sent to the contractor and a copy will be provided to the DMH Director or his designee, Deputy Director, and CDAD Chief. The DMH Director or his designee will notify the contractor in writing of the appeal decision.
- 4.5.3 At the start of every fiscal year, FAMS will send a list to Provider Reimbursement Unit and District Chiefs containing all of the contractors that met or did not meet all or any of the four criteria for the financial viability evaluation. FAMS will specify which criteria were not met for each provider.
- 4.6 On a quarterly basis, FAMS prepares a report of all contractors that did not meet all or any of the four review criteria as part of the financial viability evaluation, specifying which criteria were not met for each contractor. The report is provided to the DMH Executive Management Team (EMT) with an accompanying cover memo signed by the Director of Financial Services or Administrative Deputy.
- 4.6.1 A contractor that did not meet all or any of the four review criteria of the financial viability evaluation may be required to submit a Business Plan (BP) for any of the following reasons.
- (i) The contractor did not meet three of the financial viability criteria, or
 - (ii) The contractor's financial operations for each of the last three consecutive years resulted in losses, or
 - (iii) The contractor has a negative net worth.
- 4.6.2 The BP is to be for a period of one year and is to include a projected monthly income/expenditure statement and projected cash flow statement, and is to be supported by a statement on how the deficiency/cies is/are to be corrected.



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- 4.6.3 Contractor is to submit to the DMH on a monthly basis the actual and projected income and expenditures statement and the actual and projected cash flow statement.
- 4.6.4 If the NGO repeatedly fails to meet the DMH's financial viability requirements, the DMH lead manager for the NGO is to evaluate and recommend to the EMT the appropriate action to be taken which may be termination or non-renewal of the contract.

FINANCIAL RESPONSIBILITY REQUIREMENTS SUMMARY TABLE

Please see Attachment IV for the *Summary of Financial Responsibility Requirements Grading/Reviewing Criteria Table*.

ATTACHMENTS

- Attachment I *Non-Legal Entity Agreement Contractors - Full or Partial Waiver from Annual Re-evaluation Requirements*
- Attachment II *Request for Financial Viability Review*
- Attachment III *Financial Statement Analysis for Non-Governmental Organization (NGO)*
- Attachment IV *Summary of Financial Responsibility Requirements Grading/Reviewing Criteria Table*

REVIEW DATE

This policy/procedure shall be reviewed on or before June 30, 2014.